

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Ducheny Analyst: Marion Mann DeJong Bill Number: AB 2328

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 05/18/2000

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Biotechnology Or Technology Company Research Expenses Credit/Net Operating Loss/Allows Transfer Or Refund of Unused Tax Benefits/FTB to Report

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced February 24, 2000.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 24, 2000 STILL APPLIES.

X OTHER - See comments below.

SUMMARY OF BILL

Under the Bank and Corporation Tax Law (B&CTL), this bill would allow a biotechnology or technology company with unused tax benefits (research credit carryovers and net operating loss (NOL) carryovers) to surrender those benefits to the state for a refund equal to 50% of the value of the unused tax benefit.

SUMMARY OF AMENDMENT

The May 18, 2000, amendments made the following changes:

1. Removed the criterion that the biotechnology or technology company must have its headquarters or base of operations in this state.
2. Provided that the bill is effective for income years beginning on or after January 1, 2000, and before January 1, 2006.
3. Added a new criterion that the provisions apply only to companies conducting clinical studies on a new drug or a new biological or medical device.
4. Added a requirement for the department to report to the Legislature annually on the utilization of the credit.

The May 18, 2000, amendments resolved the constitutional consideration raised in the department's analysis of the bill as introduced. The provision regarding effective dates resolved an implementation concern regarding whether taxpayers could surrender tax benefits and claim refunds only for the current year or whether the taxpayer could request a refund for any tax year not barred by the statute of limitations. Except for these resolutions, the revenue estimate and two new implementation considerations included as numbers 9 and 10 below, the remainder of the department's analysis of the bill as introduced still applies. In addition, the following policy, implementation, and technical considerations still apply and are included below.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Legislative Director

Date

Johnnie Lou Rosas

6/26/00

Policy Considerations

This bill would set the maximum annual surrendered benefits at \$25 million per income year. An income year does not necessarily cover the same period as a calendar year or state fiscal; corporate taxpayers generally may choose to have their income year begin on any month of the year. As a result, different taxpayers have different income years. For example, income years for the year 2000 may begin in any month between January 2000 and December 2000, the latter of which would end in November 2001. Therefore, there is a 23-month period between the beginning of the first income year and the end of the last income year for each calendar year (e.g., 2000). As a result, the bill would provide an inherent advantage to taxpayers with early income years because they would be able to surrender their tax benefits and claim the refund (on their original or amended return) before those with a later income year and before the annual aggregate maximum amount of refund would be reached. The \$25 million maximum amount of surrender and refund potentially could be reached before the taxpayers with later beginning income years are able to file their returns.

Historically, fraud has been associated with refundable credits (such as the state renter's credit, the federal Earned Income Tax Credit, and the federal farm gas credit).

This bill would provide a tax benefit for taxpayers filing under the B&CTL that would not be provided to other similarly situated taxpayers that file under the Personal Income Tax Law (PITL). Thus, this bill would provide differing treatment based solely on entity classification.

Implementation Considerations

Department staff has identified the following implementation considerations. These implementation considerations would make it very difficult, if not impossible, to properly implement this bill. Additional concerns may be raised as the department continues to analyze the bill. Department staff is willing to assist the author with any necessary amendments to resolve these concerns.

1. The department has not administered a refundable tax credit under the PITL since the refundable renter's credit was suspended in 1993. The department has never administered a refundable tax credit under the B&CTL. Establishing a refundable tax benefit process would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.
2. A corporation and its affiliates would be limited to a maximum lifetime refund of \$20 million. Considering that a corporation may exist indefinitely and may have an unlimited and varying number of affiliates during those years, it would be difficult, if not impossible, for the department to ensure that the maximum lifetime refund limit is observed.
3. To administer the \$25 million annual maximum provision, the department would need to establish a tracking system to maintain a total of the tax benefits surrendered per income year.

Moreover, the bill does not specify how the department is to allocate surrender authorizations to multiple unrelated taxpayers that file simultaneously for refunds that in the aggregate exceed the maximum annual limitation amount. In addition, if the amount of tax benefits refunded during an income year does not exceed the maximum annual amount, it is unclear whether the maximum amount could be transferred to the succeeding income year and thereby increases the next year's maximum amount.

4. This bill would provide a payment to a taxpayer in exchange for unused tax benefits. Although labeled a refund, the payment has no connection to taxes previously paid. The tax treatment of this payment is unclear. For example, if the refund were considered a contribution to capital of the corporation, it would be nontaxable under federal and state tax law. However, a contribution of capital in the form of money requires a reduction in the basis of certain property held or acquired by the corporation.
5. This bill uses various terms that are not defined, such as "highly educated," "highly trained," "corporation business taxpayer," "headquarters," "new drug," and "new biological or medical device." Further, terms are used inconsistently and in an unusual context that add confusion to the provisions. Undefined terms and unclear definitions can lead to disputes between taxpayers and the department.
6. This bill does not address whether only the entire unused tax benefit or portions of the unused tax benefit may be surrendered for refund.
7. It is unclear whether the department could reduce or offset refund amounts for other amounts owed.
8. It is expected that the department would manually review the claims for refund and attached documentation since the refund amounts could be significant.
9. The NOL carryover is "post-apportionment" for each corporation within a combined report. This bill appears to use the apportionment factors to further reduce the NOL carryover before the tax rate is applied to determine the value of the surrendered NOL. If duplicate apportionment of the NOL is not intended, the bill should be changed to apply a separate manner of valuing the NOL and the credit.
10. The requirement that the department report to the Legislature states that the information to be reported is the "utilization of the credit authorized by this act." This bill does not authorize a credit; rather it authorizes a refund of certain unused credits and net operating loss carryovers. If the intent is to have the report include information regarding the surrender and refund of the research credit and NOL, the reporting requirement must be rephrased.

Technical Considerations

In defining "unused tax benefits," this bill refers to provisions of Section 23609, which prescribe carryover rules, but erroneously references subdivision (d) of Section 23609 rather than subdivision (f).

The bill refers to a biotechnology or technology company's applicable "allocation" factor, but references the "apportionment" rules as provided for in Sections 25120 to 25139, inclusive. It appears that the word "apportionment" should be properly substituted for the word "allocation" if that is consistent with the author's intent.

FISCAL IMPACT

Departmental Costs

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved.

Tax Revenue Estimate

The revenue impact for this bill is shown below:

Revenue Impact of AB 2328 Effective for income years BoA 1/1/2000 Enacted after 6/30/2000			
Losses in \$ Millions			
2000-01 -\$25	2001-02 -\$25	2002-03 -\$25	2003-04 -\$25

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

The May 18, 2000, amendments did not change the revenue estimate because the total annual refund still is capped at \$25 million per fiscal year. As explained below, the manner in which the revenue computation is estimated changed due to the May 18, 2000, amendments. That is because the requirement that a corporation must have its headquarters or its "base of operations" in California was removed and the requirement that a company must be conducting clinical studies on a new drug or a new biological or medical device was added.

The revenue impact of this proposal depends on the amount of unused R&D credit and NOL carryover and the amount of benefits that would be surrendered for refund. The revenue loss is limited to \$25 million per fiscal year.

The amount of unused research credit and NOLs for biotechnology or technology corporations was estimated based on recent corporate tax return data. For income year 2000, the estimated amounts of qualified unused R&D credits and NOL carryovers are \$190 million and \$76 million, respectively.

The surrender percentage was assumed to be 50%. From these unused credit and NOL amounts, the revenue loss without any refund limit for fiscal year 2000-2001 would be \$67 million (\$266 million times the assumed surrender proportion (50%) times the surrender price (50 cents on the dollar)). However, because of the refund limit, the revenue loss would be \$25 million per fiscal year.

BOARD POSITION

Pending.